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JAPAN AND THE NORTH AMERICAN FREE TRADE AGREEMENT

Negotiators from the United States, Canada and Mexico initiated discussions this past June to hammer out a North American Free Trade Agreement that would link more closely the three economies. Although only recently proposed, the plan to bring Mexico into the existing free trade agreement with Canada already has become a source of conflict and concern in many circles.

Among the key worries in Washington is that third countries will benefit from the pact without making the concessions required of the signatories. This issue has focused attention on Japan, a particular target of fears that nonparticipants will use Mexico as a platform from which to ship products duty-free into the United States and Canada. The Bush administration, while pointing to the advantages of any foreign investment in Mexico, has pledged to seek strong rules of origin to ensure that third-country manufacturers operating in Mexico incorporate substantial North American content into the products they send to the United States and Canada.

Mexico City, which has ambitious goals for increasing foreign investment, anticipates that strengthened ties to the economies of its northern neighbors will bolster Mexico's attractiveness to foreign investors eager for expanded access to the North American market. Yet investors outside the region see NAFTA as offering risks as well as opportunities. Japanese investment in Mexico grew quickly in the 1980s, but Japanese businesses have not completely overcome their cautiousness about Mexico's investment climate. With the prospect of NAFTA producing changes, Japanese interests are likely to weigh carefully the new opportunities and the constraints involved in increasing their presence in Mexico.

While expanded international competitiveness is a benefit held out to NAFTA participants, many business and government leaders outside North America are wary of the worldwide trend toward trade blocs, which can place economies excluded from membership at a competitive disadvantage. The potential side effects of NAFTA loom particularly large in Japan since the United States is its dominant overseas market and supplier. NAFTA will strengthen economic ties between the United States and its biggest and third-largest trading partners, possibly to the detriment of Japan, number two in two-way U.S. trade.

Background

The impetus for a free trade agreement between Mexico and the United States stems in part from developments outside North America. Not only is the European Community moving toward formal integration of the economies of its member nations but capital from European investors is expected to be channeled toward supporting the development of Eastern Europe. Japan's rapidly intensifying economic ties in the Pacific Basin also have led some American policymakers and analysts to speculate that an Asian trade alliance may become a reality. Meanwhile, the stalemate in the latest round of multilateral trade negotiations under the General Agreement on Tariffs and Trade threatens to undermine confidence in global solutions to international trade liberalization (see JEI Report No. 37B, October 4, 1991). Washington observers note that growing pessimism about the prospects of a successful conclusion to the Uruguay Round has prompted the Bush administration to pursue other options for liberalizing trade.

Against this background Mexican President Carlos Salinas de Gortari and President Bush met in June 1990 to consider expanding economic relations between the two countries and agreed to pursue a comprehensive bilateral trade agreement. The action by President Salinas represented a reversal of Mexico City's previous position, which had been that a free trade pact between the two diverse economies was unworkable. The proposal also marked another upturn in previously troubled bilateral economic relations. Mexico City's efforts since the mid-1980s to implement significant trade and investment reforms already had gone far to ease tensions over what Washington long had criticized as interventionist economic policies marked by excessive restrictions on foreign goods, services and investment.

Canada, which signed a free trade agreement with the United States that took effect January 1, 1989, asked to participate in the U.S.-Mexico talks. In June 1991 representatives from all three nations met in Toronto to launch negotiations for a North American Free Trade Agreement.

NAFTA's quick progression from the proposal stage to initial negotiations encountered some turbulence. In the United States the process was marked by intense public debate, described by one Bush administration official as

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unusual so early in a round of trade negotiations.[1] The proposed pact came into the spotlight early on as the Bush administration asked Congress to extend special procedures for congressional consideration of international trade pacts; this authority was seen as crucial for initiating the talks with Mexico. Many on Capitol Hill, some already critical of the White House's handling of trade policy issues, were wary of the anticipated agreement and anxious that the executive branch not overlook a number of problems lawmakers felt could arise from such an arrangement (see JEI Report No. 20B, May 24, 1991).

Most NAFTA discussion on Capitol Hill has focused on how the proposed agreement would affect American jobs, particularly in the automotive, steel and electronics sectors. Lawmakers have argued that lower wage rates and less-stringent environmental standards will draw American companies south. Moreover, imports from Mexico will have a negative effect in such areas as agricultural produce and apparel, these legislators say. A closely related worry has been that third countries will take advantage of Mexico's improved access to the U.S. market by using that country as a transshipment point or as a processing base for their products. From the U.S. perspective it is this concern that has linked Japan with the NAFTA discussions. Japan joins Taiwan and South Korea as the most likely third-party countries to use Mexico as a base for expanded sales to the United States and Canada. Although the role of such third countries has not been a central issue in the NAFTA debate, Washington observers note that it has had a "shadow effect" on the discussions.

Supporting Arguments from the White House and Other Advocates

The Bush administration offers a broad-based explanation of its interest in pursuing a North American Free Trade Agreement. At the Department of State counselor Robert Zoellick portrays NAFTA as "a rare opportunity to secure, strengthen, and develop our continental base economically and politically in a way that will promote America's foreign policy agenda, our economic strength and leadership, and U.S. global influence."[2] But despite this multifaceted rationale for NAFTA, advocates of the pact give center stage to the economic benefits that the arrangement could bring by creating the world's largest market -- 360 million consumers and an annual output totaling $6 trillion. The Office of the U.S. Trade Representative, for example, emphasizes the opportunities for economic growth and global competitiveness offered by regional free trade.

The emphasis on NAFTA's economic benefits reflects, in part, concerns about the significant U.S. trade shortfall with Japan and growing worries here about waning U.S. international competitiveness. Backers of NAFTA, including the Bush administration, assert that the agreement will boost the competitiveness of its participants and serve to counterbalance Japan's close economic ties to Asian Pacific countries and the strengthening EC trade bloc.

[1]Speech by Mollie Van Heuven, director, Office of Private-Sector Liaison, Office of United States Trade Representative, to Women in Government Relations, Washington, D.C., September 26, 1991.

[2]Written statement of Robert Zoellick before the Senate Committee on Foreign Relations, April 11, 1991, p. 1.

NAFTA also has been portrayed as a means of mimicking patterns believed to have contributed to Japan's economic success. The same day he and President Bush formally announced their intention to pursue a comprehensive bilateral trade agreement President Salinas noted, "The complementarity of our two economies is of strategic importance. Japan's success has been owed in part to its incorporation of its neighbors into production processes in a way that goes beyond mere trade relations. . . . [A] free trade agreement between our countries could be the answer to this extraordinary challenge."[3] The Bush administration has made the same point. In April Mr. Zoellick of the State Department told the Senate Committee on Foreign Relations, "Japanese firms increase their competitiveness and keep high-paying jobs by sourcing components in Asia. . . . A North American Free Trade Agreement is likely to channel any additional shifts of lower wage, low value-added, often assembly jobs to locations in Mexico that would be integrated with higher wage U.S. manufacturing operations."[4] Underlying this comparison is the argument that keeping low-wage jobs in this country will not help the United States compete against the high wages and sophisticated technologies of such economies as Japan's.

Once NAFTA is in effect, its supporters say, U.S. manufacturers struggling to stay competitive will not be as compelled to move their operations offshore to low-wage regions like East Asia, taking with them administrative purchasing and warehousing jobs that could have been based in this country. Mr. Zoellick and others point out, "If these jobs leave the continent, they are likely to end up in locations that feed into Japanese or other nations' high-wage manufacturing operations. By increasing efficiency and lowering the cost of inputs, higher value and higher wage U.S. manufacturing operations are likely to be better positioned to take on competition from Europe and Asia."[5] NAFTA advocates also suggest that the agreement could draw more Japanese investment into the United States, where highly skilled workers could produce components for assembly into final products in Mexico.

U.S. manufacturers, however, worry that the low cost of labor in Mexico would attract third-country producers as well as American and Canadian investors. In conjunction with the advantages of lower or no tariffs on U.S.-Mexico trade and the reduction or elimination of other barriers to cross-border transactions expected under NAFTA, this is a comparative benefit many American interests are loath to dilute by sharing it with suppliers outside the pact.

The Bush administration, in line with its philosophy that market forces should determine international direct investment flows, backs expanded access by all foreign investors to Mexico. Supporters argue that any foreign investment in Mexico will benefit the United States in the long run by spurring economic growth there and creating jobs that will ease emigration pressures.

[3]Speech by President Carlos Salinas de Gortari to the Business Roundtable, Washington, D.C., June 11, 1990, cited in U.S. International Trade Commission, Review of Trade and Investment Liberalization Measures by Mexico and Prospects for Future United States-Mexico Relations (USITC Publication 2326) (Washington, D.C.: October 1990), p. I-13.

[4]Zoellick, op. cit., pp. 6-7.

[5]Zoellick, op. cit., p. 7.

Moreover, advocates assert that geography will work in favor of the United States and that third-country investors will turn to American suppliers for components.

Conflicting Analyses and Major Concerns

Numerous studies have yielded little consensus on the impact NAFTA will have on employment, trade or investment in North America. Rep. Jim Kolbe (R, Ariz.), who strongly supports NAFTA, exclaimed that so many studies on the issue abound "You can get a study to show whatever you want."[6] The White House and other supporters of the agreement often point to the findings of an International Trade Commission report issued in February 1991. The House Committee on Ways and Means and the Senate Committee on Finance last September asked the ITC to examine the likely impact on the United States of what at that time was a proposed free trade agreement with Mexico. Among the conclusions of the resulting report was that a FTA with Mexico would provide net economic benefits to this country, but that in the near to medium term the benefits would be small compared to the size of the U.S. economy. The report added that these benefits probably would increase over time.

The ITC study also concluded that a FTA could cause some cross-border shifts in employment and could affect wage rates and the level of immigration from Mexico but probably would have little or no impact on employment levels in the United States. Similarly, the study found that a bilateral trade pact could have moderate to significant effects on U.S. trade with Mexico in several of the industries examined in the study, but that because the anticipated gains or losses in bilateral trade would represent a very small part of their domestic production the changes "would likely have a negligible impact on production levels in most of the U.S. industries, both overall and regionally."[7] The industries that would be affected most adversely by a free trade agreement with Mexico would be fruits and vegetables, the study found.

Addressing concerns that third countries could circumvent U.S. tariffs and other barriers to imports by transshipping their goods through Mexico or by using Mexico as a processing and export base, the ITC report concluded, "The nature and enforcement of the rules of origin in the agreement will determine the degree to which third countries will be able to access the U.S. market by these means."[8] FTA rules of origin are intended in large part to limit preferential tariff treatment to products that are the result of significant economic activity in the free trade region. The rules of origin included in the U.S.-Canada FTA outline a specific set of criteria for determining the country origin of goods; prior to the bilateral agreement American trade regulations did not specify the means for deciding the origin of imports.

[6]Speech by Rep. Jim Kolbe to Women in Government Relations, Washington, D.C., September 26, 1991.

[7]International Trade Commission, The Likely Impact on the United States of a Free Trade Agreement with Mexico (USITC Publication 2353) (Washington, D.C.: February 1991), p. xi.

[8]Ibid., p. viii.

Some Washington influentials are dissatisfied with existing assessments of the possible impact of a trade agreement that includes Mexico. The executive branch, noting that it would benefit from another look at the economic implications of a pact including Mexico, in early August asked the ITC to produce a study on the question based largely on recent nongovernment economic research on NAFTA. Most arguments that the proposed pact needs further study stem from Congress, which signaled its intent to play a greater role in trade negotiations during the debate this spring over whether to grant the administration's request for a two-year extension of fast-track procedures for congressional consideration of multilateral trade agreements.

House Majority Leader Richard Gephardt (D, Mo.) has spearheaded efforts to accumulate further information and analysis to aid lawmakers' assessments of the possible effects of the NAFTA negotiations. Skeptical of the predictions made by the executive branch, Rep. Gephardt and many of his colleagues have requested additional studies on NAFTA-related issues from sources outside the administration (see JEI Report No. 33B, August 30, 1991).

At Rep. Gephardt's instigation, House Ways and Means Committee chairman Dan Rostenkowski (D, Ill.) asked the ITC to conduct an analysis of several different rules of origin standards that might be used in NAFTA. In a late August letter to acting ITC chairman Anne Brunsdale, Rep. Rostenkowski indicated that lawmakers are particularly interested in the impact various rules of origin proposals would have on the North American automotive industry. Underscoring a concern voiced by many on Capitol Hill, he noted that "any origin standard for automobiles under the NAFTA should inure to the benefit of the parties to the agreement and should not invite only minimal processing or investment in order to qualify for preferential treatment."[9]

Many lawmakers seized on the importance of rules of origin to the U.S. automotive industry after Honda Motor Co., Ltd.'s U.S. subsidiary was accused in June of circumventing duties on Civics brought into the United States from its Canadian plant; Honda allegedly had overstated the North American content of the vehicles to obtain duty-free entry (see JEI Report No. 32A, August 23, 1991). Cars and trucks are among the products that must meet a North American content requirement to qualify for preferential tariff treatment under the U.S.-Canada FTA; the rule is intended to direct the benefits of the pact to the participants by limiting the third-country content of products in cross-border trade.

Most observers expect Congress will insist on a North American Free Trade Agreement that includes tough rules of origin. Rep. Rostenkowski noted, "One of the most important and controversial issues in these negotiations will be provision of adequate rules of origin to determine the eligibility of products for duty-free and other preferential treatment under the agreement. The Congress will closely scrutinize these rules to ensure that they are in the best interests of U.S. industries and workers."[10] Some on Capitol Hill also have expressed concern that adequate mechanisms be written into the agreement to ensure compliance with these rules.

[9]Letter from Rep. Dan Rostenkowski to Anne Brunsdale, acting chairman, International Trade Commission, August 27, 1991.

[10]Ibid.

Washington observers note that the lawmakers most apprehensive about Japan taking advantage of NAFTA are those allied to labor or to industries that must compete with Japanese-made products -- for example, motor vehicles, steel and electronics -- as well as those who in principle are wary of the agreement. In many cases legislators' concerns about an expanded Japanese presence in Mexico are an extension of their qualms about Japanese business practices and government policies.

Maquiladora Issue - Many congressional anxieties about Japan and other third countries taking advantage of NAFTA echo those voiced about Japanese investment in maquiladoras, assembly plants located in Mexico, largely near the U.S. border, that benefit from special American and Mexican customs treatment. Duties on products assembled in maquiladoras from American-made parts and returned to the United States are levied only on the value added in Mexico. Sales of maquiladora-assembled goods in the Mexican market currently are limited.

Japanese companies represent only a small fraction of the businesses currently operating maquiladoras, but some critics argue that Japanese manufacturers can use the program to bypass U.S. import quotas and other trade restrictions and to target more easily the American market. Some observers note that the speed with which Japanese firms availed themselves of the maquiladora program has important implications for the Japanese response to NAFTA. Japanese investment in maquiladoras rose from eight plants in 1980 to 70 within 10 years.[11] During this period the ranks of maquiladoras grew from 620 to nearly 2,000, mostly American-owned. The Japanese maquiladoras include a large number operated by electronics companies.

The February ITC study noted that the difference between maquiladoras and other production facilities in Mexico may erode under NAFTA; many of these plants, it added, may grow beyond assembly operations to become integrated foreign-owned manufacturing plants.[12] Mexico City has proposed that the existing status of the maquiladora program be retained under NAFTA. If continued in its current form, the very successful program could offer trade benefits not available to other facilities until, or even after, the provisions of NAFTA are implemented fully. However, many issues affecting maquiladoras remain to be decided.

Mexico's secretary of commerce and industrial development, Jaime Serra Puche, in early September emphasized that the nationality of maquiladora operators would not be an issue under the proposed NAFTA, although the content of inputs in maquiladora production would be discussed. Gabriel Szekely, a senior research fellow at the Center for U.S.-Mexican Studies at the University of California, San Diego, notes that from Mexico's perspective the maquiladora program long has exemplified a free trade arrangement. Existing Mexican law

[11]Gabriel Szekely, "In Search of Globalization: Japanese Manufacturing in Mexico and the United States," in Gabriel Szekely (ed.), Manufacturing Across Borders and Oceans: Japan, the United States, and Mexico (Monograph Series, 36) (La Jolla, California: Center for U.S.-Mexican Studies, University of California, San Diego, 1991), p. 121.

[12]USITC, op. cit., p. V-5.

does not subject maquiladoras to any rules of origin; thus, the plants currently incorporate a very small percent of local input. If the Mexican government does concede on this issue, Mr. Szekely says, it will have to be in response to the United States or Canada; Mexico has no interest groups pressuring the government to institute rules of origin for the maquiladora program.[13] Mr. Szekely predicts that while the maquiladora program eventually may be phased out, it will be continued until it is clear that NAFTA is going to work.

Private-Sector Concerns - Capitol Hill discussions point to the U.S. automotive industry being particularly apprehensive about Japan using Mexico to increase its sales in the United States. In 1989 Mexico exported an estimated $3 billion worth of automotive products to the United States; these shipments topped exports of manufactured goods to this country in all categories except electrical equipment. Five firms dominate car production in Mexico: the American Big Three -- General Motors Corp., Ford Motor Co. and Chrysler Corp. -- plus Nissan Motor Co., Ltd. and Volkswagen AG. The Big Three run maquiladora plants that complement their other production facilities in Mexico; Nissan does not have a maquiladora operation. Several hundred companies currently manufacture automotive parts there.

The February ITC study concluded that a trade agreement including Mexico would have an uncertain effect on the U.S. automotive industry; the most significant impact could result from the liberalization of existing Mexican restrictions on trade and investment in that sector. These include requirements that motor vehicle manufacturers maintain a trade surplus with Mexico and that both automotive manufacturers and their parts suppliers have at least 36 percent Mexican content. The study noted that were a FTA to include Mexico, the result "likely would encourage the Big Three to restructure their Mexican operations to increase their specialization, thereby achieving economies of scale and, in turn, enhancing their competitive position vis-a-vis Asian and European producers."[14]

The ITC analysis also pointed out that the investment plans of third-country firms not currently manufacturing automotive products in Mexico, particularly Japanese producers, also would factor into a trade agreement's impact on the industry. The incentive for these manufacturers to produce in Mexico "would largely hinge on whether or not they would be excluded from the benefits of a FTA, such as the removal of Mexican investment restrictions and performance requirements," the study concluded.[15]

In early September the Big Three took steps to secure their investment position in Mexico. Arguing that for several years they have worked under restrictive conditions imposed by the Mexican government, the vehicle manufacturers urged the Bush administration to negotiate preferential treatment for the five companies that, as of the beginning of this year, were the "major assemblers" of cars and light trucks in Mexico. In a letter to U.S. Trade Representative Carla Hills, Detroit recommended that local content requirements, duties

[13]Telephone interview with Gabriel Szekely, senior research fellow, Center for U.S.-Mexican Studies, University of California, San Diego, October 8, 1991.

[14]USITC, op. cit., p. xiii.

[15]USITC, op. cit., p. IV-21.

and other restrictions be phased out more quickly over a 15-year period for the five firms currently manufacturing in Mexico than for new investors. It also urged U.S. trade negotiators to "make clear to Mexico that a NAFTA agreement cannot allow Mexico to establish itself as a platform for major new automotive capacity from third country producers for export to the U.S. market."[16]

All three U.S. auto manufacturers recommended a higher regional content provision for duty-free cross-border transactions; Chrysler and Ford advocated 70 percent, while GM sought 60 percent. The firms concurred that NAFTA should establish separate, value-based automotive rules of origin, similar to the rules that apply under the U.S.-Canada FTA. They further stressed that the automotive rules of origin "be applied in such a way to specifically prevent vehicle manufacturers and suppliers from being allowed to 'roll up' non-North American materials and value in the various stages of manufacturing and assembly." Although the term is widely debated, critics see "roll up" as a means of "sneaking" more foreign content into a product by transforming foreign materials into intermediate goods that can be qualified as domestic; these intermediate goods in turn boost the local content of the final product.

The View From Mexico and Canada

Proponents of NAFTA promise that Mexico, like the United States, will become more competitive internationally with implementation of the pact. Advocates anticipate that joint ventures and shared production arrangements will give Mexico the advantage of increased access to American product and process technologies and expertise in marketing and other areas. Moreover, they say, the domestic content requirements that apply to some industries, if relaxed, could expand the range of foreign components available to Mexican companies. Yet Mexico, facing very different economic conditions than the United States and Canada, has a unique perspective on the opportunities and the problems presented by NAFTA.

Mexico City has taken significant steps in the last five years to open its markets and to ease nearly six decades of restrictive foreign investment rules. Changes made in 1989 to Mexico's foreign investment regulations have been particularly applauded in Washington, although NAFTA proponents hope the proposed pact will give foreign investors greater access to areas such as financial services, petroleum exploration and transportation. As outlined by President Salinas, the government hopes to lift total foreign direct investment to $48 billion by the end of 1994 from 1990's level of $30 billion-plus. He and other Mexican officials have indicated their expectations that NAFTA will draw foreign investment from all sources. Speaking in Tokyo in June, the secretary of commerce and industrial development emphasized that a key objective of NAFTA is to boost competitiveness in the region and that "the way to increase competitiveness is to attract investment from other parts of the world."

There has been some concern in this country that Mexico's thirst for foreign direct investment could lead Mexican negotiators to press for low regional content rules. Trade analysts report that Mexico City hopes to avoid becoming just an assembly site for companies supplying the American and the

[16]"U.S. Automakers Press for Preferences During 15-Year NAFTA Transition," Inside U.S. Trade, September 23, 1991, p. S-3.

Canadian markets; they note that the country is trying to attract manufacturers that will incorporate a significant level of local content. Yet Mexico's severe need for capital possibly makes it less wary of third-country participation than its NAFTA partners. Mr. Szekely of the University of California notes: "From Mexico's perspective, the argument that the Japanese are using Mexico as an export platform or as a means to circumvent protectionist practices in the United States misses the point. Japanese and other foreign firms are acting as agents of economic change in Mexico, helping that country orient its economy toward world markets."[17]

In some senses Japanese investment is seen as particularly attractive to Mexico. Wilson Peres, a staff economist with the United Nations Economic Commission for Latin America and the Caribbean, points out that in seeking joint venture opportunities the Mexican government frequently has pursued foreign investment "more for its intangible assets than for its addition to the level of savings available for investment." Japanese investment offers the technology transfers and entrepreneurial skills that Mexican leaders are seeking for their country, he notes.[18]

As a result, according to Mr. Szekely, "One direction Mexico will not move -- as the United States and Canada may want -- is to discriminate against foreign investors. There will be one policy for everyone."[19] Moreover, joining a FTA could give Mexico, as well as the United States and Canada, a stronger platform from which to target such shared concerns as boosting purchases of local inputs by foreign manufacturers operating in their markets and gaining greater access to Japan's markets, Mr. Szekely contends.

Canada also has a slightly different view of how Japan might factor into NAFTA. Ottawa is less inclined to push for strict rules of origin than the United States and appears less troubled by the prospect of expanded Japanese investment in Mexico. Canada's trade minister, Michael Wilson, has said that Ottawa does not see any benefit in boosting the regional content requirement for cars and trucks beyond the 50 percent required under the U.S.-Canada free trade pact. Yet Michael Hart, director of the Center for Trade Policy and Law in Ottawa, cautions, "[T]he Canadian Auto Workers and their political supporters can be expected to use the excuse of trilateral negotiations to vent their frustration at the potential erosion of Canadian participation in North American automotive production, even though this erosion is being brought about by market forces."[20]

[17]Szekely, op. cit., p. 21.

[18]Wilson Peres, "Japanese Joint Ventures with the Mexican State: The Limits of Forced Cooperation," in Gabriel Szekely (ed.), Manufacturing Across Borders and Oceans: Japan, the United States, and Mexico (Monograph Series, 36) (La Jolla, California: Center for U.S.-Mexican Studies, University of California, San Diego, 1991), p. 77.

[19]Telephone interview with Szekely, op. cit.

[20]Michael Hart, A North American Free Trade Agreement: The Strategic Implications for Canada (Halifax, Nova Scotia: Institute for Research on Public Policy, 1990), p. 105.

The Canadian automotive industry is expected to push for a 60 percent North American content provision as well as some other changes in the automotive rules included in the U.S.-Canada FTA. Other Canadian manufacturers as well as labor groups are likely to share the concerns voiced in the United States and to seek tougher rules of origin for NAFTA.

The Negotiations To Date

At their June meeting USTR Hills and her Canadian and Mexican counterparts agreed to negotiate in six broad areas; since then the trade ministers and the negotiating groups have met on a number of occasions. While the talks so far have been taken up with procedural tasks, the first formal exchange of negotiating positions occurred in mid-September when the three chief negotiators met to present tariff offers and nontariff barrier requests; their next meeting is scheduled for late October.

The three countries' NAFTA negotiators also have agreed that the major criterion for determining eligibility for duty-free benefits under the pact would be that goods coming from third countries undergo a "substantial transformation" in the region. In a late August speech Mexico's secretary of commerce and industrial development said that to guarantee substantial transformation officials had opted to apply the "tariff shift" or "tariff jump" criteria, which grants duty-free status to finished goods incorporating materials imported from third countries if the customs category under which the products leave the country is different from the categories through which incorporated parts and other inputs entered the region. The regional content test would be used as an additional factor in determining origin only in certain cases; it is likely, for example, that a percentage value-based approach will be retained for cars and trucks. This provision mandates minimum North American material and processing costs that must be represented in a final product's costs.

A number of industries prefer specific approaches to determining whether a product qualifies for duty-free status; different sourcing patterns and product lines can make certain rules more burdensome or costly to various industries. Additionally, observers note that while most U.S. industries seek strong rules of origin for NAFTA, American firms do not want to make the provisions so tough that the European Community likewise would be encouraged to enact stiffer domestic control requirements.

Trade analysts suggest that NAFTA negotiators are likely to include provisions beyond tough rules of origin to ensure that the primary benefits of the agreement accrue to the three signatories. The February ITC study noted, for example, that there is some question over whether Mexico's investment restrictions and performance requirements would apply to third-country manufacturers with U.S. operations. Observers expect the U.S. production subsidiaries of Japanese-owned companies, like their American counterparts, to expand their operations into Mexico when NAFTA goes into effect. The question of what constitutes an "American" company is likely to be scrutinized carefully in this context.

NAFTA signatories, while seeking to remove restrictive regulations on trade among themselves, will maintain their individual tariffs on third-country imports rather than adopting a common tariff for nonparticipants. Negotiators stress that the agreement will be consistent with GATT and that it will not erect new barriers to nonparticipants. NAFTA will put third countries at a

disadvantage largely by excluding them from the preferred relationship its members will share.

The View From Japan

Significantly, not only is Japan this country's second-largest trading partner (see Table 1) but it also holds the number-two position in both Canada's and Mexico's trade. The flip side of the coin is entirely different. The United States long has been Japan's dominant market and major supplier; Canada and Mexico show up far down the list of Japan's trading partners (see Table 2).

Table 1: U.S. Trade with Major Trading Partners, 1986-90*

(in millions of dollars; exports f.a.s., imports Customs)

	1986	1987	1988	1989	1990
Exports					
Canada (1)	$55,512	$59,814	$71,622	$78,809	$83,674
Japan (2)	26,882	28,249	37,725	44,494	48,580
Mexico (3)	12,392	14,582	20,628	24,982	28,279
Total Exports	227,159	254,122	322,426	363,812	393,592
Imports					
Canada (1)	68,253	71,085	81,398	87,953	91,380
Japan (2)	81,911	84,575	89,519	93,553	89,684
Mexico (3)	17,302	20,271	23,260	27,162	30,157
Total Imports	365,438	406,241	440,952	473,211	495,311

*Rank based on 1990 flows.

Source: Department of Commerce

Moreover, while Japan frequently is portrayed as seeking investment opportunities close to home, the amount of Japanese capital directed to Latin America (see Table 3) has rivaled funds channeled to Asia at various times in recent years. (To a large extent, however, the Latin American figures reflect the registration of vessels by Japanese shipping companies in Panama and the operations of financial firms in the region's tax havens.) Japan's cumulative direct investment in Mexico has grown rapidly, jumping from $776.6 million in 1982 to an estimated $1.5 billion in 1990, according to Mexican statistics. During that period Japanese direct investment in Mexico was topped only by the inflow from the United States, West Germany and the United Kingdom (see Table 4). In general, Japanese investment in Latin America is weighted heavily toward the nonmanufacturing sector, with a cumulative $34.1 billion invested there as of March 31, 1991 compared to $6.3 billion in the manufacturing sector. Mexico has been an exception to this trend, largely because of recent Japanese investments in maquiladora plants (see Table 5).

Table 2: Japan's Trade with NAFTA Participants, 1986-90*

(in millions of dollars; exports f.o.b., imports c.i.f.)

		1986	1987	1988	1989	1990
Exports						
United States	(1)	$80,456	$83,580	$89,634	$93,189	$90,322
Canada	(10)	5,526	5,611	6,424	6,807	6,727
Mexico	(23)	1,032	1,389	1,772	1,908	2,271
Total Exports		209,151	229,221	264,917	275,175	286,948
Imports						
United States	(1)	29,054	31,491	42,037	48,246	52,369
Canada	(10)	4,895	6,073	8,308	8,645	8,392
Mexico	(26)	1,439	1,625	1,591	1,730	1,931
Total Imports		126,408	149,515	187,354	210,847	234,799

*Rank based on 1990 flows.

Source: Ministry of Finance

Table 3: Japan's Foreign Direct Investment by Region, FY 1986-FY 1990

(in millions of dollars; notification basis)

	FY 1986	FY 1987	FY 1988	FY 1989	FY 1990	Cumulative March 1991
North America	$10,441	$15,357	$22,328	$33,902	$27,192	$136,185
Asia	2,327	4,868	5,569	8,238	7,054	47,519
Latin America*	4,737	4,816	6,428	5,238	3,628	40,483
Of which:						
Mexico	226	28	87	36	168	1,874
Total Investment	22,320	33,364	47,022	67,540	56,911	310,808

*Including Caribbean and other regional territories.

Source: Ministry of Finance

The Japanese government also has shown growing interest in Mexico. In September 1989 Prime Minister Toshiki Kaifu announced a $1.4 billion debt-relief package for Mexico. This was augmented by Y122.8 billion ($909.6 million at Y135=$1.00) in loans promised President Salinas when he visited Tokyo in June 1990 (see JEI Report No. 27B, July 13, 1990). Tokyo also has a stake in the debt-restructuring plan Mexico City reached with foreign bank representatives in February 1990 (see JEI Report No. 6B, February 9, 1990). Moreover,

Table 4: Cumulative Foreign Direct Investment in Mexico, 1986-90 by Country of Origin, 1986-1990

(in millions of dollars)

	1986	1987	1988	1989	1990*
United States	$11,046.6	$13,716.2	$14,957.8	$16,771.7	$19,079.7
West Germany	1,399.4	1,446.3	1,583.0	1,667.7	1,955.9
United Kingdom	556.2	987.1	1,754.7	1,799.4	1,913.8
Japan	1,037.5	1,170.3	1,319.1	1,334.8	1,455.6
Switzerland	823.0	918.2	1,004.5	1,198.9	1,346.9
France	564.9	696.1	748.5	765.0	946.0
Spain	477.3	603.1	637.2	681.2	692.0
Canada	270.3	289.6	323.5	360.9	417.0
Sweden	260.5	297.2	329.7	336.6	349.9
Italy	38.5	41.3	41.3	47.9	52.5
Other Countries	578.9	864.9	1,388.1	1,623.0	2,100.2
Total	17,053.1	20,930.3	24,087.4	26,587.1	30,309.5

*Preliminary.

Source: SECOFI, Direccion General de Inversion Extranjera, cited in Banco de Mexico, The Mexican Economy 1991.

Japan is a significant source of official development assistance to Mexico (see Table 6). In 1988 -- the most recent year for which comparative data are available -- Tokyo provided 27.7 percent of the total bilateral foreign aid Mexico received from major donor nations; 33.5 percent came from the United States, Mexico's largest source of foreign aid.

Despite Tokyo's willingness to help Mexico Japanese businesses continue to have some reservations about investing there. Using surveys conducted by Keidanren (Japan Federation of Economic Organizations) and the Japanese Chamber of Commerce and Industry in Mexico, Toru Yanagihara of Hosei University concluded that Japanese companies are encouraged by recent improvements in Mexico's macroeconomic environment. He added, however, that questions remain about that country's macroeconomic stability, Mexico City's ability to implement proper economic reforms plus policy sustainability and stability. Inadequate infrastructure and labor frustrations also pose problems for future Japanese investment.[21]

Conclusion of the NAFTA agreement undoubtedly would be seen as providing additional incentives for firms located outside the region to invest in Mexico. Yet it is difficult to generalize about possible Japanese business reactions when NAFTA itself is still in the drafting stage. Many companies are watching

[21]Toru Yanagihara, "Japanese Perspectives on Expanding Trade and Investment in Mexico," in Opportunities for Trilateral Cooperation: Mexico, the United States, and Japan (Report from Conference on Trade and Investment Prospects with Mexico held in San Diego, California, January 9-11, 1991, sponsored by The Citizens Network for Foreign Affairs), pp. 45-48.

Table 5: Japan's Cumulative Foreign Direct Investment in Mexico by Industry, March 1981 and March 1990

(in millions of dollars; notification basis)

Industry	Cumulative March 1981 Value	Cumulative March 1981 Share	Cumulative March 1990 Value	Cumulative March 1990 Share
Manufacturing	$275	33.6%	$1,001	58.6%
Food Products	15	1.8	41	2.4
Textiles	4	0.5	8	0.5
Chemicals	38	4.6	48	2.8
Metals	47	5.7	117	6.9
Nonelectric Machinery	18	2.2	44	2.6
Electric Machinery	17	2.1	38	2.2
Transportation Equipment	132	16.1	699	40.9
Other	5	0.6	6	0.4
Commerce and Services	32	4.1	191	11.2
Resource Development	510	62.3	514	30.1
Mining	500	61.1	502	29.4
Agriculture and Forestry	2	0.2	4	0.2
Fisheries	8	1.0	8	0.5
Other	1	0.1	1	0.5
Total	818	100.0	1,707	100.0

Source: Export-Import Bank of Japan, cited in Gabriel Szekely, Manufacturing Across Borders and Oceans: Japan, the United States, and Mexico (Monograph Series, 36) (La Jolla, California: Center for U.S.-Mexican Studies, University of California, San Diego, 1991), p. 117. Used with permission.

the evolution of the agreement carefully, some with concern. The response of individual foreign firms, regardless of their home base, depends greatly on their size, their existing presence in the North American market and whether they currently have operations in Mexico.

Japanese firms with facilities in Mexico might be pressed to change supplier arrangements; some Japanese-owned Mexican manufacturing operations reportedly have started shifting component sourcing to that country in preparation for the stricter regional content rules anticipated. Yet the rules of origin under NAFTA are expected to vary for certain products, making it tricky to anticipate trends at this point.

Japanese automotive manufacturers reportedly are not troubled by the proposed pact because they already have a North American production base and have targeted domestic content figures above anything that might be included in the NAFTA agreement. Some analysts expect Japanese industrial and consumer electronics manufacturers in particular to increase their investments in Mexico; financial services firms also rank high on their lists. Others dispute the

Table 6: Japan's Official Development Assistance to Mexico, 1985-89

(in millions of dollars; net disbursement basis)

	Grants			
	Grant Aid	Technical Cooperation	Loans	Total
1985	$1.6	$9.0	$8.9	$19.5
1986	---	10.9	69.9	80.8
1987	0.3	17.1	17.6	34.9
1988	1.3	16.7	20.9	38.8
1989	4.5	16.6	3.9	25.0

Source: Ministry of Foreign Affairs

latter prediction, noting Japanese financial institutions' extreme caution and Mexico City's expected reluctance to remove remaining restrictions on foreign investment in its banking sector. Japanese-owned companies also are likely to factor in an additional risk concerning investment in Mexico: too much, too soon may inflame congressional protectionist passions, already hot about Japanese investment in this country.

An Asian Trade Bloc?

Already concerned about the apparent trend toward regional trade blocs, some Japanese government and business leaders are particularly worried about the creation of a North American free trade area. Any arrangement fostering closer ties between the United States and its number-one and number-three trading partners could present risks for number-two, it is feared. A number of analysts question whether this concern about a North American fortress will drive Japan to pursue an Asian trade bloc.

Although Japanese observers emphasize that Tokyo's cool response to the East Asian Economic Group proposed by Malaysia last year reflects its lack of enthusiasm for this type of grouping, some analysts contend that Japan will face increasing pressure to join such an alliance (see JEI Report No. 12B, March 29, 1991). In fact, Japan has been moderating somewhat its views on the subject. In early October the economic ministers of the Association of Southeast Asian Nations -- which groups Brunei, Indonesia, Malaysia, the Philippines, Singapore and Thailand -- gave their support to Malaysia's proposal, which has been scaled down from the original concept of a trade bloc to a consultative forum. Tokyo, which indicated that it would wait for Asean to reach a consensus on EAEG before committing to the proposal, reportedly responded to the Asean action with qualified support for the direction the discussions were taking.

Although a number of East Asian nations were unconvinced that the EAEG as originally conceived was an answer to trading blocs, many are anxious about how NAFTA will affect their economies. Some economies in the region fear that Japanese and American investors will move production from Asia to Mexico and that their exports will be displaced by goods produced in Mexico. Predictions

vary on how severe the trade diversion might be, with some saying it will be minimal and others foreseeing significant shifts in some industries.[22]

Yet Asean, wary of cutting itself off from the United States and Europe, has been cautious about jumping into an Asian bloc, notes Tony Albrecht, an adviser to the U.S.-Asean Council.[23] Japan has invested heavily in Southeast Asia and will continue to put money in the region because of the favorable investment environment and the large market Asean offers, Mr. Albrecht predicts. Japanese manufacturers are likely to locate a production facility in Mexico rather than at an Asean site only if the plant is intended to serve the North American market, he adds.

Outlook

The North American Free Trade Agreement is far from being concluded and even further from implementation. Although Bush administration officials initially indicated the agreement could be completed by the end of this year or early 1992, trade ministers from the three nations recently conceded that the talks may go on longer than anticipated. Some in Congress and the private sector have urged the executive branch not to rush into a pact; they fear that many questions regarding the impact of NAFTA will remain unanswered or even unposed in the short run.

The timing of a NAFTA agreement has important implications. Although some critical issues could be resolved if the Uruguay Round is successfully concluded, the failure of those talks could intensify pressures for a North American free trade agreement. Some trade analysts predict that the collapse of multilateral efforts to liberalize international trade could lead to a more protectionist North American arrangement. They have an additional worry. If a draft agreement is presented to Congress early next year, election-year politics could entangle NAFTA's chances of winning Congress' approval.

Even if all three nations approve an agreement, its provisions will need to be phased in gradually to account for Mexico's lower level of economic development. The pact may not be fully implemented for another 15 years. As the agreement takes shape, political and business leaders both in North America and outside the region will be weighing the risks and the opportunities offered by NAFTA as well as its potential impact on the interplay between their economies.

[22]For a discussion of the impact of a FTA with Mexico on trade with other countries see USITC, op. cit., p. II-6.

[23]Telephone interview with Tony Albrecht, adviser to the U.S.-Asean Council, Washington, D.C., September 6, 1991.

For further information, contact Margo Grimm.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

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